ON THE RECORD

Dodd-Frank Indemnification May Hamper Transparency in OTC Derivatives

Larry Thompson, managing director and general counsel of The Depository Trust & Clearing Corp., writes about the unintended consequences of the Dodd-Frank Act's indemnification requirement for third-party regulators of U.S.-registered trade repositories.

While lawmakers and regulators on both sides of the Atlantic share the goal of enhancing transparency in the over-the-counter derivatives marketplace, there's a growing consensus that a relatively obscure provision in the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act has the potential to frustrate these efforts. With the U.S. Congress unlikely to take remedial action before 2013, the European Parliament has an opportunity to lead the international community and create sound public policy for other nations to follow.

At issue is the Dodd-Frank Act's requirement that third-party regulators indemnify U.S.-registered trade repositories before obtaining critical market data from them. Trade repositories, which are essentially large databases that aggregate and standardize detailed OTC derivatives trade data, have been endorsed by the G-20 as a critical resource designed to bring transparency and risk mitigation to the market.

When this data is consolidated in a centralized repository, relevant market positions and concentrations of risk are fully transparent to regulators. Today, over 35 of the world's leading national and regional regulators access and analyze data from DTCC's global Trade Information Warehouse for credit-default swaps to monitor trading activity in an effort to mitigate risk and help avoid another financial crisis.

Unfortunately, the Dodd-Frank Act's indemnification provision could hamper the ability of regulators and market participants to obtain this type of comprehensive and unfragmented view of the market. It will inject unnecessary complexity and dangerous delays into the process of monitoring systemic risk, and it will undo the progress that's already been made in bringing transparency to the market.

The reason is that many European regulators do not have the ability to provide indemnity to U.S.-based trade repositories. Without an indemnity agreement, these trade repositories may be legally precluded from providing supervisors market data. As a result, European, as well as Asian regulators, will have no choice but to create their own local repositories, fragmenting what should be a single global set of data into multiple local ones, each telling only a small part of the story.

DTCC's experience operating the Trade Information Warehouse for the global CDS market has demonstrated that unfragmented data plays a crucial role in helping regulators evaluate and manage systemic risk, particularly in a crisis. During **Lehman Brother**'s 2008 collapse, for example, DTCC was able to calm the international market by confirming that payouts required on CDS written on the bank was $6 billion, not the over $400 billion speculated in the media. This was possible only because all of the trades on Lehman as an underlying entity were held in one place.

The **U.S. Commodity Futures Trading Commission** recently published the final rule for repositories that offered several methods for regulators to access information. However, due to the strict letter of the law, the confidentiality and indemnification requirements were not adequately addressed and, as a result, could still produce unintended negative consequences, including fragmentation of data across multiple jurisdictions.

A technical correction to Dodd-Frank is needed, but changes likely won't take place until after the 2012 U.S. presidential elections. This creates an opportunity for Europe to take the lead and fix indemnity by establishing policies and procedures in European Market Infrastructure Regulation to safeguard data usage and sharing. Unfortunately, there is a risk that the European Parliament may instead follow the Dodd-Frank Act's example by adopting a similar reciprocal indemnification provision.

This creates the possibility for several worst-case scenarios, none of which will serve the public interest. If, for example, both the U.S. and Europe require extra-territorial third-party indemnification, it will all but ensure the fragmentation of data. However, if only one region offers indemnification and not the other, it will open the door to global regulatory arbitrage opportunities.

In the absence of a legislative fix, the **Autorité des Marchés Financiers** in Paris recently suggested a short-term solution based on equivalence and mutual recognition. The idea is that regulators would be considered in compliance with the indemnification provision in situations where they are carrying out their responsibilities in a manner consistent with international policy, such as that developed by the **OTC Derivatives Regulators' Forum**, the **Committee on Payment and Settlement Systems** and the **International Organization of Securities Commissions**.

The AMF proposal is worth further discussion, but it is not a substitute for European leadership to guarantee continued data sharing between global regulators, and to ensure the goals of transparency and risk mitigation in the OTC derivatives market are achieved.